March 2023 Capital Markets Commentary

By: Robert J. Majdecki, Senior Vice President & Chief Investment Officer

"Challenges are what make life interesting and overcoming them is what makes life meaningful."

Joshua J. Marine

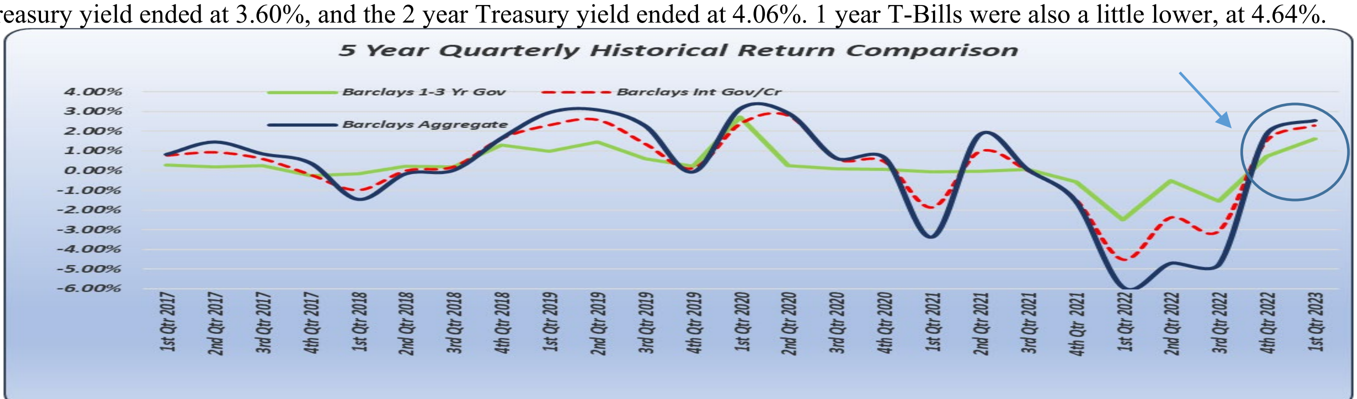
Fixed Income

As the 1st quarter ended, bonds continued their turnaround from late 2022. With the quarter ending, sensing the end of the rate hiking cycle and anticipating a recession in the coming quarters, the fixed income markets rallied on the prospects that inflation will also continue to fall as will interest rates. The Bloomberg U.S. Aggregate Index was up 2.5% in March and 3.0% for Q1, the High Yield Indies gained 1.1% in March and 3.6% for the 1st quarter, while the Barclays U.S. Aggregate was up 2.5% in March and 3.0% for the quarter. Looking deeper into the fixed income markets, longer-duration bonds outperformed those with shorter durations in the first quarter, as bond investors welcomed further declines in inflation and reached for long-term yield amidst an uncertain outlook for future economic growth

Lower yields in the belly of the yield curve, brought on by a Fed determined to stifle inflation, continued to cause bond prices to rise and yields to fall during the 1st quarter of 2023. During the quarter, the Fed and other central banks continued to raise interest rates. And to that fact, the Federal Reserve raised rate another 50 bps during the quarter, to a target of 4.75% to 5.0%.

The financial sector came under pressure in the first quarter following the failure of several U.S. banks. The Federal Reserve and the current administration along with other financial institutions put together a package that helped stem the failure tide.

As can be seen below, positive returns were the case across all spectrums during the quarter. The Barclays U.S. Aggregate posted a +2.96% return for the quarter. The Barclays Intermediate Index was at +2.33% and the short end of the curve also was positive with the 1-3 year Government Index at +1.59% for the quarter. The 10-year Treasury yield ended the quarter at 3.48%. The 5 year Treasury yield ended at 3.60%, and the 2 year Treasury yield ended at 4.06%. 1 year T-Bills were also a little lower, at 4.64%.



Fixed Income Markets - Looking Ahead

At the March meeting, the Fed raised the Fed Funds target yet again. Even with a severe banking crisis.

The bond market, at least in the near-term, may have has mispriced the Fed's willingness to tone back on rate increases. Also, the implications of tighter bank lending standards will probably take time to exhibit in overall economic data. Given the Fed "only" delivered a 25bps rate hike in March (instead of 50bps), they might be less interested in the speed at which they reach their target, and merely interested in simply making it to that target. The expectations are that interest rates might snap back to the reality of higher for longer, perhaps again reaching a terminal range of 5.50-5.75%. If that happens, the repricing of Fed expectations would send U.S. Treasury yields higher, likely causing a steeper inversion between the 2-year/10-year U.S. Treasury yield curve.

However, after one of the most intense interest rate hike campaigns in history, the Fed has signaled that it might be close to being done with rate increases. As long as that expectation for a looming end to rate hikes does not change, it'll increase the chances that the economy can achieve the desired soft landing and a recession will be short lived.

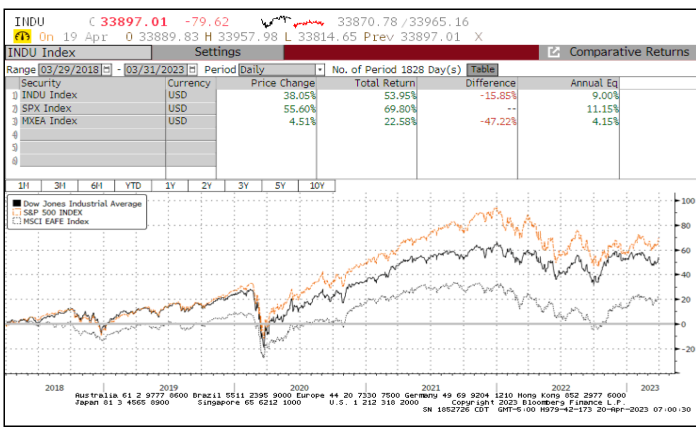
Equity

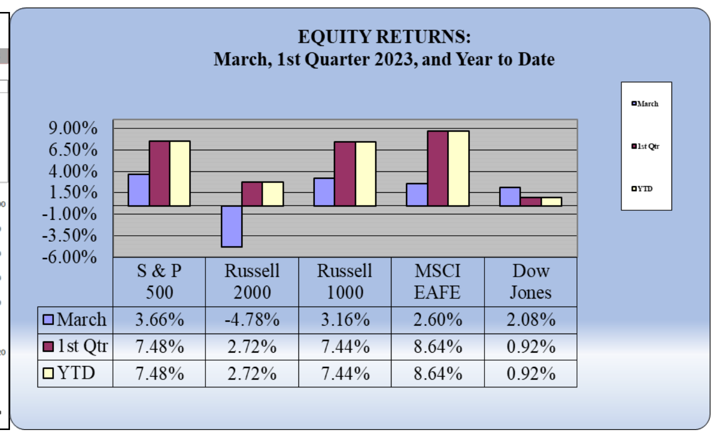
Equity markets ended the 1st quarter of 2023 on a positive note. Markets started 2023 with strong gains in January, which were primarily driven by a continued decline in inflation indicators. That decline in price pressures was coupled with shockingly resilient economic data, especially in the labor market. Those forces combined to increase investors' hopes that the Fed might be able to deliver an economic soft landing, whereby the economy slows but avoids a painful recession while inflation moves close to the Fed's target. However, February gave the market a setback as economic data implied that the labor market was still tight, and inflation was still a worry.

March began with investors still focused on inflation and potential interest rate hikes, but the sudden failure of Silicon Valley Bank, shifted investor focus to a potentially growing banking crisis. Signature Bank of New York failed just days later, and concerns about a regional banking crisis surged. The fears resided, as the Federal reserve and the Treasury Department created lending programs to shore up the system. The Federal Reserve did hike rates again in March but signaled that they were close to ending the current rate hike policy. This and no additional Bank problems eased market concerns and equity markets in March finished in positive territory.

To summarize, the markets were quite resilient in the first quarter as a looming end to rate hikes, further declines in inflation and quick and seemingly effective actions by government officials in response to regional bank failures helped shore up confidence in the banking system. Stocks and bonds both logged modest gains in the 1st quarter, despite the threat of a regional banking crisis and still-elevated market volatility.

Both U.S. and International equities were positive in the 1st quarter. On the U.S. side, the S&P 500 ended with a positive return for the quarter, showing a return of +7.48%. The Russell 1000 index returned +7.44%, the Dow returned +2.08%. The Russell 2000 was the only negative index at -4.78%. The International markets were also positive in the 1st quarter, returning +2.60%.





	S & P 500	Russell 2000	Russell 1000	MSCI EAFE	Dow Jones
March	3.66%	-4.78%	3.16%	2.60%	2.08%
1st Qtr	7.48%	2.72%	7.44%	8.64%	0.92%
YTD	7.48%	2.72%	7.44%	8.64%	0.92%

Equity Markets - Looking Ahead

<u>2023</u> – A Good Start. Last quarter, we mentioned that 2022 was the worst year for stocks since 2008. Well, 2023 is at least off to a great start.

As we move into the 2nd quarter 2023 and beyond, the markets begin facing multiple sources of uncertainty including the path of inflation, future economic growth, the number of remaining Fed rate hikes, and whether the regional banking crisis is truly contained. However, the markets have proven resilient over the past six months since hitting their lows in October of 2022. And, while there are many headwinds that remain in place, the markets will likely stay volatile, and there remains a path for future positive returns.

While some headwinds have begun to dissipate, new headwinds such as deposit flight out of regional banks have begun to stir. The markets are close to the top of their current trading range, and the near-term market forecast is that it will need to see a turnaround in leading economic indicators to break through the top of this range and rally upward to where fair value can be attained.

As we move into 2023, we still have a bright light in the tunnel to look for. As we progress through the 1st half of the year, monetary tightening is either at, or close to, an end (We Hope). However, the market will be looking for increase in leading economic indicators to begin viable long-term rally.

The Economy

The Economy

Through the first two months of the year, financial market performance appeared somewhat balanced, with February's broad-based weakness serving as a counterbalance to January's strong showing. The events that unfolded across the U.S. banking system throughout March, however, dominated financial media headlines and conversation circles, as the failures of Silicon Valley Bank (SVB) and Signature Bank rekindled fears of contagion within the U.S. banking industry and broader financial markets. Across the pond, Credit Suisse's longer-term operating struggles ended abruptly on March 19, with Swiss authorities forcing a merger with rival UBS.

The Federal Reserve raised interest rates twice in the 1st quarter, bringing the federal funds rate to around 5%, its highest level since 2007. These higher interest rates increase the cost of borrowing for consumers and corporations, putting downward pressure on demand broadly. As a result, consumer confidence has moderated, and corporate earnings growth has been revised lower. For 2023, S&P 500 earnings growth is now expected to be around 1%, well below the 10% growth estimate expected mid-2022.

With the rate hikes, the most highly anticipated recession in U.S. economic history has so far failed to materialize, as the 2.6% growth at which the economy closed 2022 has been followed by first quarter growth in 2023 that will likely come in around 3.0% when the first estimate is released at the end of April. The consumer continues to spend at a high real (inflation-adjusted) rate as the tight labor market has provided both strong job security, which boosts confidence, and ample wage growth, which fuels purchases. And as mentioned, although the inflation rate has dropped, it is still high in real terms.

The Economy - Looking Ahead

Economic Growth? Jobs? Inflation? Recession? Global problems? Changes keep occurring.

It's still not too early to predict that a recession will hit the U.S. economy at some time during 2023 or early 2024. It will happen. This prediction stems comes from the inverted yield curve, where the spread between the yields on the 10-year and 2-year Treasury bonds is the most negative in 40 years. However, how persistent will inflation be? And where are interest rates headed? "These are complicated questions that depend on many variables, including investor psychology. Currently, central banks around the world are following differing paths, and all are weighing a range of outcomes rather than committing to a single answer.

Markets appear to have priced in expectations for a soft landing, but that may be too optimistic. After the Fed announced its fourth consecutive rate increase of 75 basis points in November, Fed Chair Jerome Powell warned that "the ultimate level of interest rates will be higher than expected." However, the economy slowed down and inflation seemed to be dropping.

Even after accounting for the fact that monetary policy acts with a lag from when the Fed first begins to raise interest rates, the U.S. economy has been more resilient than first projected. However, the projection is that tight monetary policy will take its toll and result in stagnant economic growth in the second and third quarters. Forecasts are that real annualized U.S. gross domestic product of 2.6% in the first quarter will drop to 0% in the second quarter, contract by 0.8% in the third quarter, then reaccelerate to 0.4% in the fourth quarter.

It appears likely that the economy will be somewhat stagnant and may potentially fall into a modest recession. There are expectations that inflation will continue its gradual deceleration to lower levels, but slowly. However, it seems overly optimistic for inflation to fall from approximately 5% currently to the Fed's stated goal of 2% over the next year. Given persistent core inflation, it seems likely that bond yields, which have already fallen sharply due to the banking crisis, may fall only moderately further outside of recession or renewed bank concerns, resulting in rate cuts.

More than likely, a mild economic downturn remains possible and may begin sometime in the second half of 2023. The economy could expect to see consumption fall and the labor market to soften, although more moderately than in past recessions, with the unemployment rate perhaps remaining below 5%. Inflation should moderate, with core inflation heading lower by year-end. In this backdrop, the Fed is likely to pause hiking interest rates sometime in 2023. *But, inflation is a tricky thing, and we may have to wait until 2024 to see a drop in rates.*
